The Outlook for the Latin American Economy

Brazil lacks recovery momentum, Argentina suffers stagflation and Mexico faces downward risks

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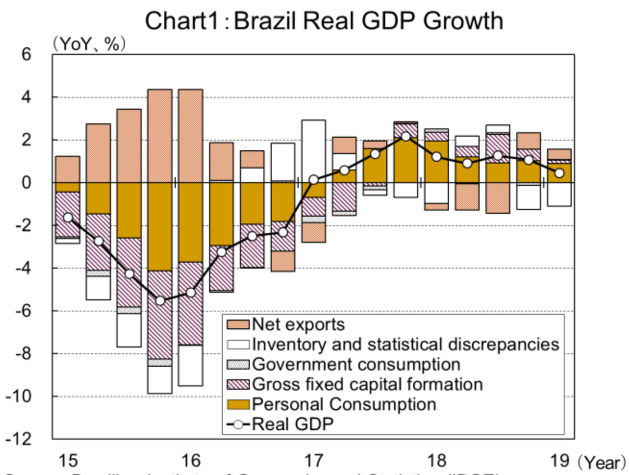
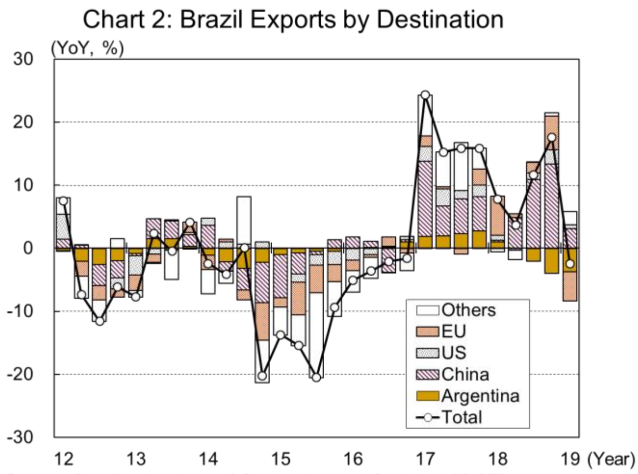
1. Brazil

As the Brazilian economy stagnates, the country's real GDP growth slowed significantly in the January-March quarter to a 0.5% year-over-year (YoY) gain from a 1.1% rise in October-December 2018 (Chart 1). In a quarter-over-quarter (QoQ) comparison, the GDP declined 0.2%, the first contraction in two years. Domestic factors that contributed to the slowdown include inventory adjustments and disruption in mining activities due to a collapse of a mining dam. As for exports, growth in China-bound exports slowed significantly (Chart 2). Exports to Argentina, which is suffering stagflation, continued to fall YoY. Exports to the European Union also dropped YoY. The Brazilian economy has been on a recovery track since 2017, lagging behind the global economic expansion slightly. However, the economy now faces downward pressure from a global slowdown, before the upward momentum could gain traction.



Source: Brazilian Institute of Geography and Statistics (IBGE), Institute of International Monetary Affairs

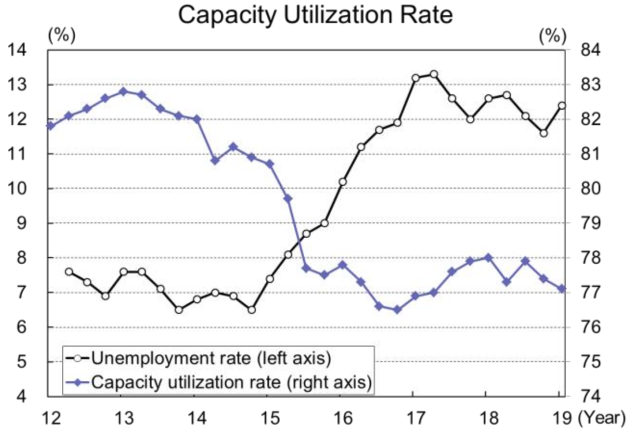


Source: Brazilian Institute of Geography and Statistics (IBGE), Institute for International Monetary Affairs

Reflecting the sluggish economy, unemployment rate rebounded to 12.4% in the January-March quarter, and manufacturing capacity utilization rate fell to 77.1%. The slack in the labor market and capital utilization has improved little since the economic downturns of 2016 and 2017 (Chart 3 next page). The slow recovery has eroded tax revenues in fiscal 2019, forcing the government to cut expenditures mid-year. In May, students protested against education budget cuts, while the government denied cutting the budget. The fiscal strain is surfacing through other public projects and could weigh on the economy.

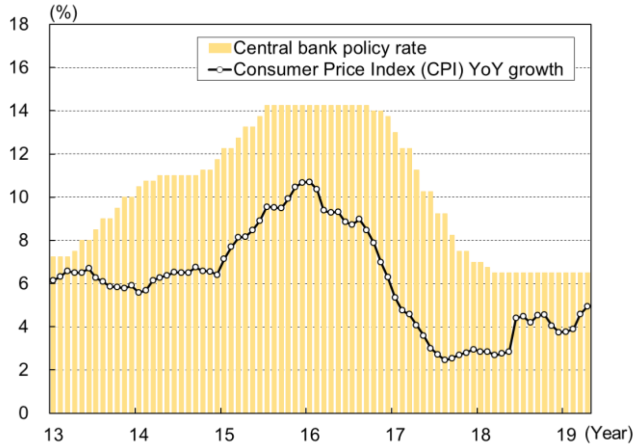
With labor and capital utilization low, inflation has stabilized at low levels. In April, the Consumer Price Index (CPI) rose 4.9% YoY, falling within the 2.75-5.75% range targeted by the central bank (Chart 4). The policy rate has been kept unchanged since March 2018 at 6.5%, the lowest level since 1999.

Chart 3: Brazil Unemployment Rate and Capacity Utilization Rate



Source: Brazilian Institute of Geography and Statistics (IBGE), Institute for International Monetary Affairs

Chart 4: Brazil CPI and Central Bank Policy Rate



Source: Central Bank of Brazil, Institute for International Monetary Affairs

In the second half of this year, production is expected to rise as halted mining activities resume, but economic recovery is likely to remain slow for some time. Exports are expected to languish as key trade partner Argentina's economic recovery is not in sight till next year, and Chinese and European economies also lack momentum. Due to the fiscal strain, government spending likely will negatively contribute to the GDP. The real GDP is projected to grow 1.2% YoY in 2019, a third straight year of muted growth around 1.0%. In 2020, growth is expected to accelerate to 2.0% as manufacturing adjustments around the world run their course and domestic demand picks up on low interest rates.

Pension reform is seen as a potential breakthrough for the stagnation of recent years. President Jair Bolsonaro's administration has launched efforts to revamp the pension system as a first step of structural reform. Under the current system, some individuals qualify for pension benefits as young as age 52, noticeably young compared with other countries. The government plans to gradually raise the retirement age and increase the minimum length of contribution required to receive benefits. The aim is to save a little over 1 trillion reais over the next 10 years in order to lighten the burden of the government and companies. Needless to say, pension cuts will be "painful," so the process would be no smooth-sailing, including congressional deliberations. Nonetheless, even if the reform target is not fully achieved, a half of the initially proposed cost savings would mark a major progress. This could fuel anticipation for medium-term growth through brighter business sentiment and market upturns. Congress deliberations should be followed closely.

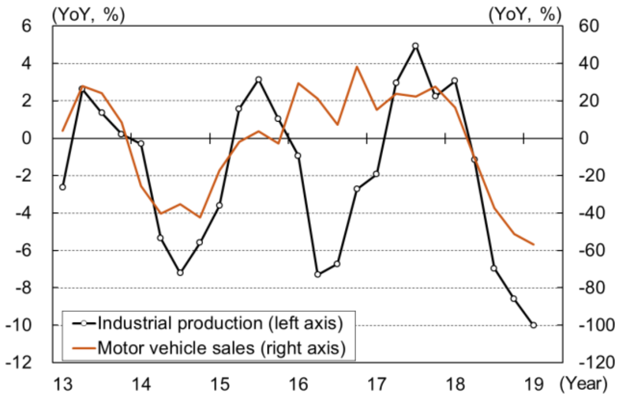
2. Argentina

Argentina continues to suffer stagflation of weak economic growth and high inflation following the May 2018 currency crisis. Its 2018 real GDP declined 2.5% YoY, and the slowdown continues in 2019. Industrial production fell 9.7% YoY in the January-March quarter, nearing a double-digit decline. Motor vehicle sales tumbled 56.7% YoY (Chart 5), while inflation remained severe. The CPI rose 6.5% MoM in September 2018, and the increase narrowed to 2.6% in December (Chart 6). Yet inflation accelerated this year as utility charges rose and pushed up prices of other goods and services. In order to avoid declines in real income, labor unions have demanded greater wage raises. As a result, annualized inflation rate reached 56.6% in January-March.

Opinion polls show that President Mauricio Macri's approval rating is declining on the back of the tough economic conditions, while former President Cristina Fernandez is gaining support. While in office, Fernandez had a clash with the International Monetary Fund and foreign investors, and deepened diplomatic relations only with leftist governments. Her policies pushed nationalization of companies, import restrictions, and freezing of retail prices. As a result of bringing much turmoil to the economy, she lost the 2015 election to Macri. Fernandez, however, still has a strong support base owing to her policies favorable to low-income people. On May 18, Fernandez said she would support Alberto Fernandez' candidacy as president and she would run as vice president. Alberto Fernandez, who is not a relative of the former president, is considered more of a centrist and thus could garner broader support.

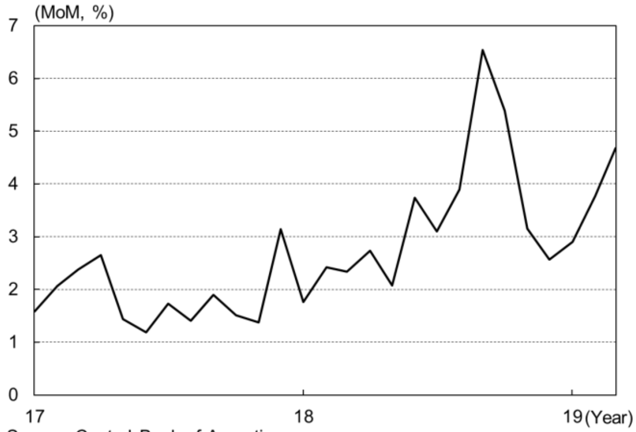
The two Fernandezes are therefore likely to be the eye of the storm in the presidential race. Macri is being forced to revisit his strategies, and investment likely will be held off through November due to policy uncertainties. Meanwhile, high inflation is expected to drag down consumption for some time. The real GDP is projected to decline 2.0% YoY in 2019, falling for a second straight year. Argentina's top priority continues to be reining in inflation. Whoever wins the election will would need to take austerity measures. In 2020, tame inflation is expected to support the economy but the real GDP growth will still be muted, at around 0.5% YoY.

Chart 5: Argentina Industrial Production and Motor Vehicle Sales



Source: National Institute of Statistics and Census (INDEC), Institute for International Monetary Affairs

Chart 6: Argentina Consumer Price Index



Source: Central Bank of Argentina, Institute for International Monetary Affairs

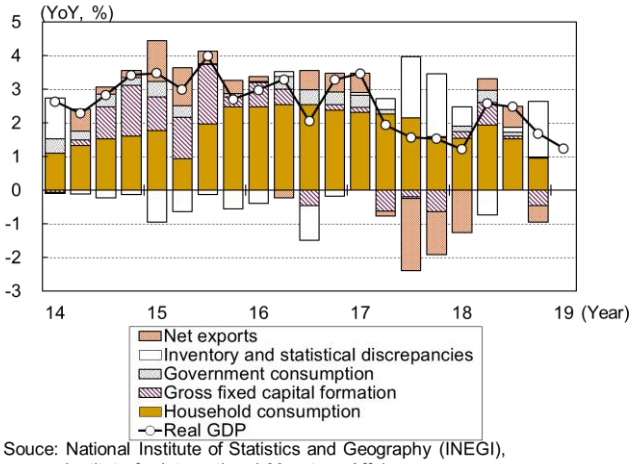
3. Mexico

The Mexican economy has been expanding but the pace has slowed somewhat. The real GDP rose 1.2% YoY in the January-March quarter, easing from a 1.7% increase in the October-December quarter (Chart 7). By industry, primary industries fared well with a 5.8% gain. Secondary industries declined 0.7% as mining fell 7.6% and construction slid 0.8%. Tertiary industries rose 1.9%, slowing from the previous quarter's 2.7% increase. Meanwhile, inflation is gradually taming. The CPI climbed 4.9% YoY for all of 2018. In the January-March quarter of this year, however, the increase narrowed to 4.1% (Chart 8). The central bank's policy rate has been kept at 8.25% since December.

Going forward, sources of concern abound in external conditions. Mexico's biggest trade partner, the US, is expected to go into a mild economic slowdown. US President Donald Trump on May 30 threatened to impose 5% tariffs against Mexico, with plans to raise the rate in phase to 25% eventually. Trump is accusing Mexico for not doing enough to curb illegal immigration to the US. Mexico's exports to the US amounted to $347 billion in 2018. So a 5% tariff would translate to about $17.4 billion in cost to Mexico. The figure is equivalent to 1.5% of Mexico's nominal GDP for 2018. A 25% tariff would therefore surely slow down the economy. Yet at this point, even if the tariffs are introduced, they are unlikely to stay long because the threat was prompted by illegal immigration rather than trade matters and the Mexican government plans to discuss countermeasures with the US.

Meanwhile, monetary and fiscal policy could underpin the economy. Based on President Andres Manuel Lopez Obrador's campaign promise to narrow economic disparities among different regions, public works are expected to pick up in the second half of this year. As for monetary policy, taming inflation is creating room for a rate cut if needed. Mexico's real GDP is expected to rise about 2.0 YoY in 2019, the same rate as 2018. In 2020, growth is projected to slow slightly to 1.7% due to the US economic slowdown.

Chart 7: Mexico Real GDP Growth



Souce: National Institute of Statistics and Geography (INEGI), Institute for International Monetary Affairs

Chart 8: Mexico Consumer Price Index

Souce: National Institute of Statistics and Geography (INEGI), Institute for International Monetary Affairs

Translated by Chie Okada-Wighe

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